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No. 24

In the Supreme Court of the United States

OCTOBER TERM, 1942

MARINE HARBOR PROPERTIES, INC., PETITIONER

v.

MANUFACTURERS TRUST COMPANY, AS TRUSTEE; MAURICE RUBLINGER, TRUSTEE OF MARINE HARBOR PROPERTIES, INC., ET AL.

ON WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE SECOND CIRCUIT

BRIEF FOR THE SECURITIES AND EXCHANGE COMMISSION

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BRIEF FOR THE SECURITIES AND EXCHANGE COMMISSION

The Securities and Exchange Commission became a party to the present proceeding for the reorganization of Marine Harbor Properties, Inc., under Chapter X of the Bankruptcy Act,[1] participated as an appellee before the Circuit Court of Appeals, and is named respondent herein.

This brief for the Commission is in support of the petitioner.

[1] The Commission became a party pursuant to the provisions of Section 208 of the Bankruptcy Act (11 U. S. C., Sec. 608).

OPINIONS BELOW

The opinion of the District Court (R. 70–75) is reported in 41 F. Supp. 814. The opinions of the Circuit Court of Appeals (R. 107–126) are reported in 125 F. (2d) 296.

JURISDICTION

The decree of the Circuit Court of Appeals was entered on January 27, 1942 (R. 126). The petition for a writ of certiorari was filed February 13, 1942, and granted March 16, 1942. The jurisdiction of this Court rests upon Section 240 (a) of the Judicial Code, as amended by the Act of February 13, 1925.

QUESTION PRESENTED

Section 141 of the Bankruptcy Act provides that a petition filed by a debtor under Chapter X shall be dismissed if not filed in good faith. Section 146 provides that, without limiting the generality of the term "good faith," a petition shall be deemed not to be filed in good faith if "(4) a prior proceeding is pending in any court and it appears that the interests of creditors and stockholders would be best subserved in such prior proceeding." The question presented is whether, under these provisions, a bankruptcy court must relinquish the jurisdiction conferred upon it by Chapter X upon a mere showing that

a state court has continuing jurisdiction over the trust which holds the mortgage on the debtor's property and that the petitioning debtor company once consented to an extension of the mortgage in the state court proceedings, and without any showing that the interests of the debtor's creditors and stockholders would there be better safeguarded than in proceedings under Chapter X.

STATUTE INVOLVED

Section 141 of the Bankruptcy Act of July 1, 1898, c. 541, 30 Stat. 544, as amended (11 U. S. C., Sec. 541) provides as follows:

> Upon the filing of a petition by a debtor, the judge shall enter an order approving the petition, if satisfied that it complies with the requirements of this chapter and has been filed in good faith, or dismissing it if not so satisfied.

Section 146 of the Bankruptcy Act of July 1, 1898, c. 541, 30 Stat. 544, as amended (11 U. S. C., Sec. 546) provides in part as follows:

> Without limiting the generality of the meaning of the term "good faith", a petition shall be deemed not to be filed in good faith if— * * *. (4) a prior proceeding is pending in any court and it appears that the interests of creditors and stockholders would be best subserved in such prior proceeding.

STATEMENT[2]

The Debtor's principal asset is an apartment building in New York City, which is subject to a first mortgage of $370,000 (R. 76). This mortgage is held by the respondent, Manufacturers Trust Company (successor by merger to The Mortgage Corporation of New York), as trustee for approximately 90 certificate holders. There are also junior mortgages (R. 79). On the basis of an affidavit concerning its value (R. 56), the property appears to be worth less than the amount of the first-mortgage debt (R. 71).

When originally created in 1931, the first mortgage was held by Title Guarantee & Trust Company, which issued and sold to the public certificates of participation therein, guaranteed as to principal and interest by Bond and Mortgage Guarantee Company (R. 8). In 1933, nearly all mortgage guarantee companies in New York State

[2] Because this case has been characterized by respondent mortgage trustee's attorney, in a letter dated March 28, 1942, to the Clerk of this Court, as being "generally regarded as involving a test as to whether approximately $700,000,000 in principal amount of certificated mortgages covering real estate in New York City and immediately adjoining counties will be reorganized under a procedure established by the New York Legislature or pursuant to the procedure provided in Chapter X of the National Bankruptcy Act," the statement of the case here presented has been broadened to make clear the nature of the procedures established by the New York Legislature and to show that these procedures are involved in the present case only to a limited extent.

including Bond and Mortgage Guarantee Company, were in financial difficulties as a consequence of the impact of the depression upon real estate and the resulting widespread defaults in the payment of interest, taxes, and principal.[3] It therefore became necessary for the Superintendent of Insurance to take over the mortgage guarantee companies for rehabilitation or liquidation pursuant to Article XI of the New York Insurance Law;[4] in the case of Bond and Mortgage Company, the Superintendent of Insurance took possession of its property and business in August 1933 (R. 8–9).

In the course of his efforts to rehabilitate the mortgage guarantee companies, the Superintendent had necessarily to consider problems involving the rights of the certificate holders in the mortgages which secured their investments. Emergency legislation was deemed essential to meet the special problems of this aspect of the mortgage guarantee situation.[5] The need was partially met by the Schackno Act[6] which con-

[3] Report of George W. Alger, Commissioner of His Excellency Herbert H. Lehman, Governor of the State of New York, dated October 5, 1934 (herein referred to as the Alger Report), at p. 3.

[4] Alger Report, p. 5.

[5] Annual Report of the Mortgage Commission of the State of New York, 22 N. Y. Leg. Doc. (1939) No. 94 (herein referred to as Final Report, Mortgage Commission), p. 3.

[6] N. Y. Laws 1933, c. 745 as amended; N. Y. Unconsolidated Laws, Secs. 1796 *et seq.*

ferred additional powers on the Superintendent of Insurance and established a statutory state court procedure applicable to certificated mortgage issues. This legislation was supplemented in 1935 when the Legislature adopted the Mortgage Commission Act,[7] which provided an alternative state court procedure, and which created the Mortgage Commission of the State of New York as an independent statutory representative of the certificate holders and as administrator of the certificated bonds and mortgages. The Superintendent of Insurance retained his functions as rehabilitator of the guarantee companies.

These emergency statutes recited as their purpose the protection of the guarantee companies against claims on the guarantees arising from defaults on the underlying mortgages.[8] To that end they provided statutory procedures to prevent or cure defaults by (1) adjusting the legal relations of the certificate holders so that effective action could be taken in their behalf without the necessity of obtaining their unanimous consent; and (2) creating powers for modifying the certificated mortgages so that the security for the certificate holders' claims could for the time being be adequately preserved.[9] The procedure finally evolved accom-

[7] N. Y. Laws 1935, c. 19 as amended; N. Y. Unconsolidated Laws, Secs. 1751 *et seq.*

[8] Schackno Act [L. 1933, c. 745, as amended], Section 1; Mortgage Commission Act [L. 1935, c. 19, as amended], Section 1.

[9] Final Report, Mortgage Commission, at p. 4.

plished the first of these purposes by concentrating the powers of certificate holders in individual trustees who would take possession of the certificated bonds and mortgages from the Mortgage Commission and who would, pursuant to declarations of trust, administer them as trust estates on behalf of certificate holders. Effective servicing of the mortgages pending the appointment of such trustees was facilitated by empowering the Superintendent of Insurance, and later the Mortgage Commission, to promulgate proposals for the extension and modification of the mortgages which could be made binding upon all certificate holders upon the acquiescence of two-thirds indicated affirmatively or by failure to dissent.

In the instant case, these statutes were utilized fully. First, the Superintendent of Insurance sought to preserve the certificated mortgage by promulgating, pursuant to the powers granted by the Schackno Act, a proposal for the extension of the mortgage and participation certificates and a reduction of the interest requirements (R. 9). With the consent of the Debtor and the holders of two-thirds in principal amount of the certificates, this proposal was approved by the Supreme Court of Kings County, New York, on December 6, 1934 (R. 52); Title Guarantee & Trust Company and the Debtor then entered into the extension agreement necessary to give effect to the terms of the Superintendent's proposal. Under this agreement the mortgage was extended to December 1, 1937,

upon condition that the Debtor pay interest at the contract rate of 6% per annum to December 1, 1934, and thereafter at 5% to December 1, 1937 (R. 10). Second, in order to provide a permanent administration of the trust estate, The Mortgage Commission promulgated a proposal for the appointment of a trustee for certificate holders (R. 11). On December 6, 1938, with the required consent of the certificate holders, the state court approved this proposal and designated the Mortgage Corporation of New York (to which the respondent Manufacturers Trust Company is successor by merger) as trustee (R. 38). The declaration of Trust (R. 22) created a trust estate consisting of the bond and mortgage and vested in the trustee "all the rights and powers of an absolute owner of the property * * *." The Declaration contained an enumeration of comprehensive powers; but it provided also that the trustee should not extend the bond and mortgage, reduce the rate of interest, release any property, or sell the securities or the property, without the permission of the court by order obtained after ten days' notice by mail addressed to the certificate holders. The order of the state court appointing the trustee (R. 38) also provided:

> Ordered that this Court, having assumed jurisdiction of this proceeding, shall retain jurisdiction hereof until the complete liquidation of the Trust Estate and the termi-

nation of the trust; and the Trustee, or any other interested party herein, may apply at the foot of this Final Order upon such notice as the Court may direct for such other and further relief as to the Court may seem just and proper.

By September 1939, trustees had been appointed in substantially similar fashion for all but a negligible fraction of the mortgages and properties which had come into the hands of the Mortgage Commission,[10] and that Commission's existence was terminated.[11] In each instance, the appointment of trustees for a certificated issue served as a complete fulfillment of the purposes of the temporary[12] Schackno and Mortgage Commission Acts. Since their appointment, and in accordance with the terms of their declarations of trust, the trustees have serviced the mortgages, distributing available proceeds to certificate holders and accounting annually to the courts of appointment.[13] New defaults on the part of mortgagors were encountered either by reason of the expiration of the interim extension agreements or because of an

[10] Final Report, Mortgage Commission, at p. 5.

[11] The Mortgage Commission Act was amended in 1939 (L. 1939, c. 944) so as to terminate the Commission in September 1939, and transfer its duties and powers under that Act to the Superintendent of Insurance.

[12] The effectiveness of the Schackno and Mortgage Commission Acts has been continued in force from time to time by amendments; both Acts expire July 1, 1943 (L. 1942, cc. 315, 638).

[13] Final Report, Mortgage Commission, at p. 7.

inability to meet the fixed charges under them. These situations the trustees have met either by foreclosure of the certificated mortgages or by negotiating with the mortgagors for a new extension or modification and submitting the negotiated agreements to the courts of appointment for approval whenever required by their declarations of trust."[14]

Thus, in the present case, the principal of the first mortgage was not paid at its extended maturity in 1937 and remained an "open" mortgage under the statutory moratorium.[15] The Debtor made all other payments due under the 1934 extension agreement until April 1, 1941, when it defaulted in payment of interest and taxes (R. 12). On numerous occasions, both before and after default, the Debtor and The Mortgage Corporation of New York negotiated for an agreement of further extension and modification which the trustee could, pursuant to the declaration of trust, submit to the court for approval (R. 62). On October 11, 1940, the Debtor submitted to the respondent mortgage trustee a proposal that the mortgage be extended for five years, with interest reduced to 4% per annum, and with amor-

[14] *Id.* at pp. 8, 9.

[15] By statute, foreclosure for principal defaults was suspended in New York for an emergency period (L. 1933, c. 793). The emergency period has been extended by amendment and now expires July 1, 1943 (L. 1941, c. 782).

tization at 2% per annum. This the trustee declined to entertain, taking the position that interest should be at the rate of 4½% per annum. The Debtor's proposal was never submitted to the court or to the certificate holders. (R. 14.)

On May 1, 1941, the mortgage trustee began foreclosure proceedings in the Supreme Court, Kings County; a receiver was appointed and entered into possession of the mortgaged property (R. 12). On August 11, 1941, while the foreclosure proceeding was pending in its initial stages, the Debtor again submitted to the mortgage trustee a proposal that the mortgage be extended for five years, with interest at 4½% and amortization at 1½%. The trustee rejected this proposal and did not submit it to certificate holders or to the court of appointment (R. 14).

The Debtor then filed its voluntary petition under Chapter X of the Bankruptcy Act on September 17, 1941 (R. 76). The petition was approved on the same day and reorganization trustees appointed by the District Court (R. 96). Thereafter, the mortgage trustee applied to the District Court to vacate the order of approval and dismiss the petition as not filed in good faith (R. 7).

The District Court denied the application (R. 4, 70). The Circuit Court of Appeals reversed (R. 111), Judge Frank dissenting.

SPECIFICATION OF ERRORS TO BE URGED

The Circuit Court of Appeals erred—

(1) In holding that the Debtor's petition was not filed in good faith.

(2) In directing the District Court to dismiss the petition.

SUMMARY OF ARGUMENT

I

The Debtor's petition was not lacking in good faith within the meaning of Section 146 (4). That section precludes a petition under Chapter X only in the event that there are prior pending proceedings which best subserve the interests of the creditors and stockholders. The proceedings pending in the New York courts do not satisfy the requirement that they best subserve the interests of the creditors and stockholders in this case.

The Schackno Act, under which the state court proceedings were pending, is not, in contrast to Chapter X, a vehicle for the reorganization of debtor corporations in which public investors are interested, but rather is concerned primarily with the relationship of holders of certificated mortgages *inter sese* and their relationship to the guarantors of the mortgage. Many of the usual incidents of proceedings for the reorganization of debtors are lacking in the Schackno Act and its later complement, the Mortgage Commission Act. Thus the debtor and its property are amenable to the juris-

diction of the state tribunal only upon the debtor's consent, and the state procedure prescribes no means for securing adherence to standards of fairness in proposed plans. Where fairness requires that junior claimants relinquish their interests, separate foreclosure proceedings or voluntary relinquishments are the only alternatives.

This case exemplifies the inadequacies of the state procedures. The available remedies provided by the Schackno and Mortgage Commission Acts had been exhausted, negotiations between the Debtor and the trustee appointed under the latter Act had broken down over the interest and amortization rates, and separate foreclosure proceedings had been begun.

The nature and procedures of Chapter X, on the other hand, stand in sharp contrast. That chapter is designed for the permanent rehabilitation of a corporate debtor while safeguarding the interests of security holders. Provision is made for a disinterested trustee, for expert assistance through the Securities and Exchange Commission, for full disclosure to security holders, and for other safeguards, few of which are present in the state procedures. It is plain, therefore, that neither the state court procedure nor the history of the Debtor's attempts at adjustment thereunder warrants the conclusion that the interest of investors would best be served by dismissal of the Debtor's petition.

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H

The Debtor's conduct in failing to seek further relief in the state court after it had assented to an extension therein did not constitute such lack of good faith as to require dismissal of its petition. To hold that mere participation in pending proceedings bars a petition under Chapter X is to overlook the fact that under Section 146 (4) prior pending proceedings are to bar such a petition only if such proceedings best subserve the interests of the creditors and stockholders.

But in any event, the Debtor was not personally disqualified from filing the petition. A debtor's conduct prior to the Chapter X petition should carry little weight in Chapter X proceedings since the right of creditors to be protected is paramount and since a debtor does not ordinarily remain in possession, but rather control of the proceedings passes to the court and disinterested trustees. Even if, however, prior conduct may in some instances constitute lack of good faith, it is plain, under applicable authorities, that the prior conduct here was not of such a character. The debtor is given the right to pursue its remedy under Chapter X; its participation in the state proceedings had been limited and incidental; and the state proceedings had, for all practical purposes of reorganization, run their course. Accordingly, even under broad standards of the term "good faith," the Debtor was not barred by his conduct from filing a Chapter X petition.

ARGUMENT

THE DEBTOR'S PETITION WAS NOT LACKING IN GOOD FAITH WITHIN THE MEANING OF THE ACT

Introductory.—The federal bankruptcy power is, of course, paramount over competing prior proceedings pending either in state or federal courts. Cf. *International Shoe Company* v. *Pinkus*, 278 U. S. 261; *Stellwagen* v. *Clum*, 245 U. S. 605. This principle of paramountcy is expressly reaffirmed and embodied in Chapter X, which provides not only that the institution of specified proceedings constitutes a substitute for an act of bankruptcy permitting creditors to petition for relief under Chapter X,[16] but also that—

> A petition may be filed under this chapter notwithstanding the pendency of a prior mortgage foreclosure, equity, or other proceeding in a court of the United States or of any state in which a receiver or trustee of all or any part of the property of a debtor has been appointed or for whose appointment an application has been made.[17]

Congress did not, however, exercise the paramount federal power to the exclusion of every other legal process. While the pendency of other proceedings alone is no bar to the assump-

[16] Bankruptcy Act, Sec. 3 (a) (4), (5), 3b, 102, 131; 11 U. S. C. 21a (4), (5), 21b, 502, 531.

[17] Bankruptcy Act, Sec. 256, 11 U. S. C. 656.

tion of jurisdiction by the reorganization court,[18] Congress nevertheless provided, by Section 141, that such jurisdiction should not be exercised unless a proceeding under Chapter X were instituted in good faith. And, further, in order to preclude utilization of Chapter X in such a manner as to defeat rather than accomplish the objective of protecting public investors, Congress provided in Section 146 (4) that a petition is not to be deemed as filed in good faith where another court proceeding is pending "and it appears that the interests of the creditors and stockholders would be best subserved in such proceedings."

In this case, the Debtor was involved in state court proceedings only in a limited sense; its property was never *in custodia legis* until 1941 when receivers were appointed in the foreclosure proceeding. The state court proceedings were not primarily concerned with the Debtor at all, but had been instituted in August 1933 by the Superintendent of Insurance in order to rehabilitate the guarantor of the first mortgage of the Debtor's property. In order to preserve the mortgage, the Superintendent proposed extension of the mortgage and modification of its requirements. The holders of the certificates and the Debtor consented to the proposal and entered into an agreement effectuating the proposal. While other events occurred subsequently—the

[18] The court below held that there was jurisdiction in this case (R. 111). See also *Brooklyn Trust Company* v. *Rembaugh*, 110 F. (2d) 838, 840 (C. C. A. 2).

creation by the state court in 1938 of a trust estate and appointment of a trustee, continued but unsuccessful negotiations between the Debtor and the trustee relative to further extension and modification of the mortgage, and finally, institution by the trustee of foreclosure proceedings and appointment of a receiver—two facts are outstanding. First, the Debtor was at no time the prime mover in the state court proceedings, and, indeed, its only participation, other than the fruitless negotiations directly with the trustee concerning the terms of the mortgage, was its consent to the Superintendent's proposal in 1934 to extend and modify the mortgage. Second, no comprehensive reorganization was ever submitted to the state court, none was discussed, and, indeed, no party, either the Debtor, the trustee, or any creditor, came forward with a plan. From 1933, when rehabilitation of the guarantor was begun, until 1941, when this case was instituted, no plan for the reorganization of the Debtor was, so far as the record shows, even contemplated. The state court "reorganization" during the entire time comprised only the 1934 extension and modification of the mortgage, the appointment of the trustee in 1938, and the abortive subsequent efforts by the Debtor to obtain further extension and modification, which never reached the state court.

Upon the basis of these circumstances, a majority of the court below held that the Debtor's petition for reorganization under Chapter X must be

dismissed because it was not filed in good faith. The precise basis of its conclusion is not wholly clear: The court seems to have held that Section 146 (4), relating to prior proceedings, did not govern this case; on the other hand, it also held that there was no absence of good faith "in the broad meaning of those words" (R. 111). Rather, the court held, there was a "special instance of lack of good faith flowing from the personal disqualification of the debtor" (R. 111). In the court's view, such "personal disqualification" apparently lay in the Debtor's assent to the 1934 modification and extension of the mortgage, and its subsequent payment to the trustee in conformity with the revised terms (R. 110).[19]

[19] That it was the "assent" or participation of the debtor in the state court proceedings which constituted the governing circumstance appears from a comparison of *Brooklyn Trust Company* v. *Rembaugh*, 110 F. (2d) 838 (C. C. A. 2), and *In re Castle Beach Apartments, Inc.*, 113 F. (2d) 762 (C. C. A. 2). In the *Rembaugh* case, the debtor had "assented" to the "reorganization" of the mortgage (*i. e.*, to the appointment of the trustee) and was, accordingly, held to be "in the position of one who voluntarily submitted the plan for the reorganization in the state court" (p. 840); accordingly, the debtor's petition under Chapter X was dismissed as not filed in good faith. In the *Castle Beach* case, on the other hand, although there was a similar state court "reorganization" proceeding, the debtor, who had purchased the property from the owner who had originally mortgaged the property, was not a "party" to the state court proceedings. The court held that the petition was filed in good faith, stating (p. 763) that there had been no state court proceeding for the reorganization of the debtor and "even had there been, that alone would not have been adequate ground for the dismissal of the petition."

We submit, however, that lack of good faith cannot be found in this case to arise either from the pendency of prior proceedings within the meaning of Section 146 (4) or in a "personal disqualification" supposedly resulting from the Debtor's conduct in assenting to a proposal made in the state court proceedings. Neither of these factors is such as to require the bankruptcy court's surrender of its paramount jurisdiction.

A

The petition cannot be deemed not to have been filed in good faith merely because of the existence of prior proceeding, since the interests of creditors and stockholders would not be best subserved in such prior proceeding

Under the terms of Section 146 (4), the fact that prior proceedings are pending precludes the invocation of Chapter X only in the event that such proceedings best subserve the interests of creditors and stockholders of the debtor. We submit that the court below was correct in holding (R. 111) that good faith was not lacking within the meaning of that subsection.

To determine whether or not prior pending proceedings will best subserve the interests of creditors and stockholders, it is necessary to compare the procedures available under such proceedings and those available under Chapter X. The comparison readily establishes that the state court proceedings here involved were not such as to fulfill the requirements of Section 146 (4).

Initially, it should be noted that Chapter X and the procedures provided under the New York laws differ fundamentally in purpose and in their fields of application and operation. They are not designed to attain the same, or even substantially similar, objectives.

Chapter X is a vehicle for the reorganization of debtor corporations in which public investors are interested. The Schackno Act, on the other hand, is only incidentally concerned with the debtor at all; its primary concern is the relationship of holders of certificated mortgages *inter sese* and their relationship to the companies which had guaranteed the mortgages.[20] It is an emergency measure designed to provide a procedure which would enable holders of certificated mortgage investments, through the agency of the Superintendent of Insurance, to modify their claims against their primary obligors (the mortgage debtors) without impairing their claims against the guarantee companies. For this purpose, the Act provided that with the approval of the state court a modification or extension of the mortgage to

[20] "* * * the Schackno Act is designed, not for the relief of the debtor and its creditors, but for the reorganization or rehabilitation of the certificate holders of a mortgage. It may well be that that act provides a comprehensive scheme for the reorganization of certificated mortgages, but there the relief stops." *In re Coney Island Hotel Corp.*, 9 F. Supp. 329, 332 (E. D. N. Y.), reversed on other grounds, 76 F. (2d) 126 (C. C. A. 2).

which two-thirds of the certificate holders assented, which was found to be fair, would become binding upon all certificate holders; it cannot, however, be made binding upon mortgagors without their consent. Although this procedure, therefore, bears some similarity to a reorganization device, it is more significant that, except as here noted, all of the usual incidents of proceedings for the reorganization of debtors are lacking.[21] Thus, neither the debtor nor its property becomes amenable, save upon consent, to the jurisdiction either of the Superintendent or the

[21] Accordingly, we submit that the Schackno Act and Mortgage Commission Act proceedings should not even be deemed "prior proceedings" for the purpose of determining good faith under Chapter X. In enacting Section 146, Congress intended to codify judicial interpretations of the general "good faith" provision of Section 77B. (See S. Rep. No. 1916, 75th Cong., 3rd Sess. (1938) at p. 27.) Moreover, Congress has, by specific enumeration elsewhere in Chapter X, attributed to the words "prior proceeding" a connotation similar to that found in the good faith cases under Section 77B. See Sections 113, 131, 148, 256 (11 U. S. C. A. 513, 531, 548, 656). In the concept employed in those cases, the phrase "prior proceeding" had reference only to a proceeding in which the assets of a debtor were *in custodia legis* for the primary purpose of rehabilitation or distribution for the benefit of claimants. See, for example, *In re Wixin & Golub, Inc.*, 84 F. (2d) 1 (C. C. A. 2); *Hickey v. The Ritz-Carlton Restaurant & Hotel Co., of Atlantic City*, 96 F. (2d) 748 (C. C. A. 3); *Brockett* v. *Winkle Terra Cotta Co.*, 81 F. (2d) 949 (C. C. A. 8); *Snyder* v. *Fenner*, 101 F. (2d) 736 (C. C. A. 3); *In re Knickerbocker Hotel Co.*, 81 F. (2d) 981 (C. C. A. 7). By this standard the state proceedings are not "prior proceedings" within the meaning of the statute.

state tribunal, nor is provision made for the proof and allowance of claims or for the recovery of assets fraudulently conveyed. The only coercive remedies available to certificate holders, or to the Superintendent, against the recalcitrant mortgagor are to be had outside the framework of the Act through conventional legal or equitable process, primarily foreclosure.

The Shackno Act was supplemented in 1935 by the Mortgage Commission Act, which established the Mortgage Commission of the State of New York as the independent statutory representative of certificate holders, and provided an alternative procedure which included provision for the appointment of permanent trustees.[22] These trustees were to acquire from the Mortgage Commission (as successor in this respect to the Superintendent of Insurance) the underlying bonds and mortgages securing the certificated mortgage investments and were to administer the assets thus acquired for the ratable benefit of the certificate holders.

The trusts resulting from the operations of the provisions of the Mortgage Commission Act have been carried out under separate declarations of

[22] Although plans to become effective under the Schackno Act require the affirmative assent of two-thirds of certificate holders, plans may be made effective under the Mortgage Commission Act unless one-third of the certificate holders register a positive dissent. Mortgage Commission Act [L. 1935, c. 19 as amended], Section 7.

trust which follow generally a standard form, although the pattern has varied in detail among the different counties in New York State.[23] The trustees are vested under the trust instrument with all the rights and powers of absolute owners of the certificated bonds and mortgages, and the trusts continue until the assets in the estate have been fully liquidated. Once permanent trustees are appointed, the emergency legislation has fully served its purposes as related to the administration of certificated issues; thereafter the trustees function under the powers delegated to them by the declaration of trust. Their powers pursuant to these declarations are limited only to the extent that extensions of the bond and mortgage, reductions in interest, and sales of securities and properties covered thereby, require the permission of the court. Thus, the whole proceeding is similar in nature to a proceeding in which the estate holding mortgage securities in the estate applies for instructions concerning a proposed agreement with the mortgagor. The fiduciary deals with the mortgagor as an outsider, and the court proceedings merely provide sanction for the fiduciary's action. And although the declarations of trust usually require that the court's approval be upon notice to security holders, there is no requirement that the

[23] See Spitz, *The Administration of Guaranteed Mortgage Trusts*, contributed article, N. Y. Law Journal, Jan. 6, 7, 8, 1942.

security holders accept the trustees' proposals by special vote.[24]

Plans approved under the Schackno or Mortgage Commission Acts, and presumably those approved pursuant to declarations of trust, must conform to the requirement that they be fair, reasonable, and equitable to the holders of the mortgage investments. However, the state procedures provide no means for securing adherence to this standard if it is to be given the content which it has in the Bankruptcy Act. *Case* v. *Los Angeles Lumber Products Co., Ltd.*, 308 U. S. 106; *Consolidated Rock Products Co.* v. *DuBois*, 312 U. S. 510. Where compliance with the standard of "fairness" requires that the junior claimants relinquish the whole or a portion of their interest, separate foreclosure proceedings are the only available alternatives to voluntary concessions by such claimants. This inadequacy of the state procedures has of necessity induced plans which, in the main, provide for short extensions of the mortgage, reduction of interest rates, suspension of

[24] See S. E. C. Protective Committee Study, Vol. VI, p. 188. Under some declarations of trust, proposals for extension of mortgage for less than a specified number of years may be effectuated by the trustees without notice to security holders and without application for the approval of the state court. For example, the declaration of trust in *In re Paloma Estates, Inc.*, 126 F. (2d) 72 (C. C. A. 2), petition for certiorari filed May 12, 1942, No. 89, this Term, provides for notice to security holders only when the proposed extension is for more than three years and the court directs that such notice be given.

amortization payments, and the like, without compensatory advantage to senior claimants.[25] Cf. *Consolidated Rock Products Co.* v. *DuBois, supra.* Furthermore, there is no mandatory requirement of feasibility, and the plans of the type just described have the frequent consequence that, at the end of the period of extension, neither payment nor refunding of the mortgage is possible,[26] and resort to further proceedings must be had.

The instant case exemplifies the inadequacies of the state procedures. The bond and mortgage are now held by Manufacturers Trust Company (as successor to The Mortgage Corporation of New York) pursuant to the declaration of trust created in 1938 (R. 38). Under the broad powers granted to the trustee (R. 22), negotiations were conducted with the Debtor looking to a new extension and modification of the mortgage to replace the three-year extension which expired in 1937. Although the mortgage trustee acknowledged the "top heavy" condition of the mortgage (R. 20), it never proposed or attempted to consummate any more feasible or permanent reorganization than an extension, with the added feature of a 2%

[25] Annual Report, Mortgage Commission, at p. 5; cf. Alger Report at p. 78.

[26] See *Brooklyn Trust Company* v. *Rembaugh*, 110 F. (2d) 838 (C. C. A. 2); *In re Paloma Estates, Inc.*, 126 F. (2d) 72 (C. C. A. 2), petition for certiorari filed May 12, 1942, No. 89, this Term; *In re Castle Beach Apartments, Inc.*, 113 F. (2d) 762 (C. C. A. 2); *In re Blinrig Realty Corp.*, 114 F. (2d) 100 (C. C. A. 2).

annual amortization of principal (R. 14), and the break-down in negotiations with the debtor resulted from disagreement merely as to whether the aggregate amortization and interest rate should be 6 or 6½% per annum.

The remedies afforded by the Schackno and Mortgage Commission Act procedure and the resulting trust procedure, all of which require an agreement with the debtor, had thus been exhausted, and the trustee has instituted foreclosure proceedings. It is apparent, however, that the foreclosure must either end in a forced sale, the result of which for the security holders is a matter of extreme uncertainty, or it must serve as the procedural vehicle for a reorganization according to the well-known pattern of equity receiverships.[27] But it was this very type of inadequate equity procedure which Chapter X, and its predecessor, Section 77B, were designed to supplant. See *Securities and Exchange Commission* v. *United States Realty & Improvement Co.*, 310 U. S. 434, 448.

[27] There can be no contention that the foreclosure proceeding has progressed so far that the maintenance of the Chapter X petition would have been adverse to the interests of the investors, since no plan had been approved or even promulgated, nor other similar definitive step completed in the foreclosure proceeding at the time the petition under Chapter X was filed. Cf. *In re Mt. Forest Fur Farms of America*, 103 F. (2d) 69 (C. C. A. 6), certiorari denied, 308 U. S. 583; *In re Surf Bldg. Corp.*, 11 F. Supp. 295 (E. D. Ill.); *In re Prairie Avenue Bldg. Corp.*, 11 F. Supp. 125 (E. D. Ill.).

The nature and procedures of Chapter X of the Bankruptcy Act stand in sharp contrast to those provided by the New York acts. In Chapter X, Congress provided the procedure which appeared, after exhaustive inquiry,[28] best designed for the permanent rehabilitation of debtor corporations and the protection of the interests of the investors. This Court has, in the *United States Realty & Improvement Co.* case (*supra*, at pp. 449–453) recently appraised the features of Chapter X designed to make it an adequate vehicle for the reorganization of corporations in which public investors are interested. As was there observed, Chapter X safeguards the interests of security holders while providing an adequate remedy for the permanent reliabilitation of a corporate debtor. Provision is made *inter alia* for the appointment of a disinterested trustee who will investigate and report concerning the debtor's financial and managerial problems; for securing "impartial and expert administrative assistance" through participation in the proceedings by the Securities and Exchange Commission (*id.*, 449); for assurance that security holders will not be required to vote on any proposed plan of reorganization until they

[28] S. Rep. No. 1916, 75th Cong., 3rd Sess. (1938); H. Rep. No. 1409, 75th Cong., 1st Sess. (1937); S. E. C. Report on the Study and Investigation of the Work, Activities, Personnel and Functions of Protective and Reorganization Committees, Parts I–VIII.

have received full information concerning the plan[29] and until the plan has been initially approved by the court as fair and equitable;[30] and for "control by the court over security holders' committees and the formulation of reorganization plans" (*ibid.*).

The state court procedures provide practically none of the basic safeguards to be found in Chapter X for the protection of investors. There is no provision for the appointment of a disinterested trustee charged with the investigatory and reporting functions imposed by Section 167 of the Bankruptcy Act; there is no provision authorizing participation in the proceedings by a permanent administrative agency adequately staffed;[31] there is no requirement that a plan must be found

[29] Bankruptcy Act, Sec. 175, 11 U. S. C. 575.

[30] Bankruptcy Act, Sec. 176, 11 U. S. C. 576.

[31] The state court justices having jurisdiction over the procedures applicable to guaranteed certificated mortgage issues were authorized in 1940 [Ch. 764 of the New York Laws of 1940, amending Section 17a of the Mortgage Commission Act; N. Y. Unconsolidated Laws, Section 1768] to select certain persons and endow them with the customary powers of a state court referee, for the purpose of aiding the courts in supervising the functionings of trust estates created under the Mortgage Commission Act. On May 10, 1940, the justice handling certificated mortgages in the Second Judicial Department of the State (comprising the counties of Kings, Queens, Nassau, Suffolk, and Richmond) by order appointed James F. Donlan, Esq., for such purpose in that Department, and for convenience designated Mr. Donlan's office as the "Bureau of Trust Supervision." We have been unable to find any published material relating to this office and describing its mechanics and activities.

to be fair and equitable and feasible and approved by the court before the assent of security holders may be solicited, or that information adequate to supply a basis for an informed judgment be furnished to security holders in connection with such solicitation. Wholly absent also are the safeguarding provisions found in Section 216, subdivisions (10), (11), (13),[32] relating to the form and substance of reorganization plans. In sum, the superiority of Chapter X over the state procedures is even clearer than its superiority over Chapter XI of the Bankruptcy Act. See *Securities and Exchange Commission* v. *United States Realty & Improvement Co., supra.* See also Note (1934) 34 Col. L. Rev. 663; Note (1935) 35 Col. L. Rev. 874; Note (1941) 18 N. Y. U. L. Quarterly Review 339, 418; Siegel, *Chapter X or Schackno Act Proceedings* (1941) 27 Corn. L. Q. 56.

It is plain, therefore, that neither the state court procedure here involved nor the actual history of the attempts at adjustment warrants the conclusion that the interests of investors would best be served by the dismissal of the Debtor's petition under Chapter X.[33]

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[32] 11 U. S. C. 616 (10), (11), (13).

[33] Section 146, in defining good faith, was intended by Congress to be a "codification" of some of the judicial interpretations of that phrase under Section 77B. See S. Rep. 1916, 75th Cong., 3rd Sess. (1938), p. 27. See also *supra*, note 21. And it is clear that the instant case falls within that category of decisions holding that no lack of good faith arose from the pendency of prior proceedings. See e. g.,

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The debtor's conduct did not constitute lack of good faith so as to require dismissal of the petition

While Section 146 defines four situations in which a petition for reorganization under Chapter X shall be deemed not to have been filed in good faith,[36] it also provides that these definitions shall not limit "the generality of the term 'good

In re Cloisters Bldg. Corp., 79 F. (2d) 694 (C. C. A. 7), certiorari denied, 296 U. S. 657; *In re Knickerbocker Hotel Co.*, 81 F. (2d) 981 (C. C. A. 7); *Union National Bank v. Lehmann-Higginson Grocer Co.*, 82 F. (2d) 969 (C. C. A. 10); *In re South Coast Co.*, 8 F. Supp. 43 (D. Del.); *In re Prairie Ave. Bldg. Corp.*, 11 F. Supp. 125 (E. D. Ill.); *In re Surf Bldg. Corp.*, 11 F. Supp. 295 (E. D. Ill.). In special circumstances, of course, Section 77B proceedings were held not to supersede pending state court proceedings. See e. g., *In re Electric Public Service Co.*, 9 F. Supp. 128 (D. Del.) (petition dismissed where state court had already approved a plan of reorganization in a pending receivership proceeding and receiver had already sold all assets pursuant to the plan); *In re Williamsport Wire Rope Co.*, 10 F. Supp. 481 (M. D. Pa.), appeal dismissed, *Williamsport Wire Rope Co. v. Bethlehem Steel Corp.*, 78 F. (2d) 1023 (C. C. A. 3) (petition dismissed where plan had already been partially consummated in state court receivership proceeding and plan proposed by petitioner under Section 77B found not feasible, practicable, or acceptable). But plainly the facts of these latter cases are not comparable to those presented here.

[36] The petition shall be deemed not to have been filed in good faith if (1) the petitioning creditors have acquired their claims for the purpose of filing the petition; (2) adequate relief would be obtainable under Chapter XI; (3) it is unreasonable to expect that a plan of reorganization can be effected; or (4) a prior pending proceeding would best subserve the interests of creditors and stockholders.

faith' ". Although the court below held that there was no "absence of good faith * * * in the broad meaning of those words" (R. 111), it must have been proceeding under the "generality" clause, for it undertook to direct dismissal of the petition because of an asserted "lack of good faith flowing from the personal disqualification of the debtor", (*ibid*). This "personal disqualification" the court apparently found to arise because the Debtor had once consented to an extension of the mortgage, approved by the state court, and had not applied to the state court for further relief after the extension expired. This conclusion, we believe, overlooks the express statutory standards and is clearly erroneous.

Although for the sake of convenience, in order to follow the treatment of the issue by the court below, we discuss the issue of "personal disqualification" as separate from the question whether there was a lack of good faith within the meaning of subsection (4) (see Point A, *supra*), we state initially the view that such a dichotomy is, for present purposes, unreal. In enacting subsection (4), Congress clearly intended a comprehensive definition of the circumstances in which resort to Chapter X is to be precluded by the pendency of prior proceedings. Whatever lack of good faith there may be here, and we suggest there is none, clearly arises out of the prior proceedings. Therefore, if the assumed lack of good faith is to bar resort to Chapter X, it must be coupled, we submit, with

the further circumstance that the prior proceedings best serve the interests of the creditors and stockholders; otherwise the Chapter X petition is not, for that reason, vulnerable. Were the decision of the court below to be accepted, Section 146 (4) would thereby be modified to provide in effect that a petition is to be deemed not filed in good faith *either* if the prior pending proceedings best serve the interests of creditors or stockholders, *or, regardless of the interests of creditors and stockholders,* if the debtor actively participated in such proceedings. An amendment of this nature would eliminate the former express standard, since, except in rare instances,[35] it is difficult to envisage cases in which the debtor did not in some way participate in the prior pending proceedings.

But apart from this factor, we submit that in any event the Debtor's conduct did not constitute bad faith.

Initially, it is important to note that the concept of bad faith in the sense of personal disqualification of a petitioning debtor must, because of the nature of Chapter X, play a highly restricted role. Whether or not personal disqualification of a *debtor* might deprive it of "its legal right to

[35] In *In re Castle Beach Apartments, Inc.*, 113 F. (2d) 702 (C. C. A. 2), the petitioning debtor was held not to be disqualified; he had participated in the state court proceedings only to the extent that he had subsequently purchased the property from the original debtor-owner in connection with a foreclosure proceeding. See *supra*, note 19.

have its property administered in bankruptcy,"[36] the right of *investors* to have their interests protected by the remedial provisions of Chapter X should not normally be abridged. Indeed, "personal disqualification" appears to have no place in those Chapter X proceedings in which the debtor is not to remain in possession.[37] Personal disqualification may have had some relevance in cases under Section 77B or in "friendly receiverships," for in those proceedings the intentions and motives of the debtor who instituted the proceedings were significant because of the continuing dominance of those controlling the debtor in the administration of the estate and because of "the power of the old management to play a role in the formulation of the plan."[38] But these factors are absent under Chapter X. The decisions of this Court in *Case* v. *Los Angeles Lumber Products Co., Ltd.*, 308 U. S. 106, and *Consolidated Rock Products Co.* v. *DuBois*, 312 U. S. 510, and the express provisions of Chapter X, make clear that an improper motive of the debtor need be no obstacle to the successful prosecution of the proceedings in the interests of security holders. In pro-

[36] *In re Koch*, 116 F. (2d) 243, 247 (C. C. A. 2).

[37] In all cases where the debtor's liabilities exceed $250,000, a trustee must be appointed; in cases involving smaller liability the judge may appoint a trustee or may continue the debtor in possession. Bankruptcy Act, Sec. 156; 11 U. S. C. 556.

[38] Circuit Court Judge Frank dissenting (R. 122).

ceedings under Chapter X, upon the approval of the petition, control of the debtor's property and of the proceedings passes from the debtor to the court and its trustee and, in a measure, to the security holders; the debtor as such no longer plays a dominant role in the proceedings. *In re Porto Rican American Tobacco Co.*, 112 F. (2d) 655 (C. C. A. 2). Indeed, the more questionable may be the motives of the debtor, or those who control it, the more need there may be for the bankruptcy court to assert its comprehensive jurisdiction and make available to investors the remedies and safeguards of Chapter X.

Accordingly, the concept of personal disqualification of the debtor is of doubtful applicability under Chapter X in any circumstances.[39] See Note (1941) 18 N. Y. U. L. Quarterly Review 399, 412–413; cf. Finletter, *The Law of Bankruptcy Reorganizations* (1939), pp. 75, 77–78; Note (1934) 48 Harv. L. Rev. 283, 284, n. 2. Since, therefore, the very nature of a Chapter X proceeding requires an interpretation of personal disqualification constituting bad faith far narrower than that warranted in equity receiverships and in Section

[39] Thus it has been suggested that even *In re Wisan & Golub*, 84 F. (2d) 1 (C. C. A. 2), where a debtor's petition under Section 77B was held not to have been filed in good faith because the debtor had concealed its assets, is not applicable to Chapter X proceedings. Note (1941), 18 N. Y. U. L. Quarterly Review 399, 413, n. 117; cf. Finletter, *The Law of Bankruptcy Reorganizations* (1939), p. 75.

77B cases, the court below attached undue significance to the asserted personal disqualification.

But in any event, the Debtor's conduct, if tested by the standards obtaining under the older types of proceedings, would not constitute a personal disqualification. The mere fact of a debtor's filing a petition under the Bankruptcy Act when some state proceeding might be available does not constitute bad faith. And as this Court has held in a proceeding under Section 75 (s) of the Bankruptcy Act, a debtor should not be charged with bad faith because he takes the course provided for him by Congress. *John Hancock Mutual Life Insurance Co.* v. *Bartels*, 308 U. S. 180, 185. On the same basis, *i. e.*, that "bad faith cannot attach to adopting a course afforded by Congress," a debtor who was in a state court receivership has been held not to be disqualified from filing a petition under Section 77B. *In re South Coast Co.*, 8 F. Supp. 43, 45 (D. Del.).[*]

[*] It has been held, however, that circumstances may be such that resort to Section 77B is not in good faith. Thus in *In re Cook*, 104 F. (2d) 981 (C. C. A. 7), a creditor's petition was dismissed as not filed in good faith where the petitioning creditors, trustees under a bondholders' protective agreement, were defendants in a state court proceeding in which it had been alleged that they had engaged in fraudulent conduct and in which an injunction and accounting were sought. The trustees obtained a 60-day extension of time to render the accounting, but on the 50th day filed a petition under Section 77B. The evidence was

No different conclusion is warranted because the Debtor consented to the 1934 extension and modification of the mortgage and, in 1940 or thereafter, failed to present its limited proposal for further extension and modification to the state court after it had been rejected by the trustee. Whether the Debtor had the power itself to present an application to the state court for further relief is a question on which the majority of the court below and the district judge were in disagreement (see R. 110, 71–72, 74–75; see also dissenting opinion of Judge Clark in *In re Paloma Estates, Inc.*, 126 F. (2d) 72, 75). The Debtor itself clearly assumed that the state court's reservation of jurisdiction in the 1938 order (*supra*, pp. 8–9) did not empower it to make such an application (R. 62, 67–68). And even if we were to assume that the Debtor was empowered to apply directly

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held to show that the purpose of the petition under Section 77B was to escape the state court's order to account (p. 985). The court held that the petition was filed in bad faith, stating (*ibid.*) that its purpose was not to benefit a corporation in financial distress, but to "escape jurisdiction of another court where the day of reckoning of their alleged acts of misconduct was at hand." It is to be noted that a similar rule had been enunciated for ordinary bankruptcy proceedings, for the institution of which there was no statutory requirement of good faith. *Zeitinger* v. *Hargadine-McKittrick Dry Goods Co.*, 244 Fed. 719 (C. C. A. 8), certiorari denied, 245 U. S. 667. Whatever the applicability of these cases to Chapter X proceedings (see *supra*, pp. 32–35), it is clear that the petitioners' conduct and motives there are in no way comparable to the Debtor's conduct and motives here.

to the state court, it seems apparent that such a course would have been entirely futile, not only because of the flat opposition of the trustee (*supra*, pp. 10–11), but also because of the clear inappropriateness of the available state court proceedings for the task of comprehensive reorganization which appeared to be necessary (see R. 67–68, *supra*, pp. 21–26). In the light of these circumstances, it cannot be concluded that the Debtor's failure to apply to the state court for relief constituted a personal disqualification amounting to bad faith even under the most rigid interpretation of those terms.[41] Indeed, we have been unable to find any case involving Section 77B proceedings in which it was held that participation in state court proceedings *per se* disqualifies the debtor from resort to Section 77B. Rather, the contrary has been held. *Union National Bank* v. *Lehmann-Higginson Grocer Co.*, 82 F. (2d) 969 (C. C. A. 10) (Section 77B petition held filed in good faith although debtor had

[41] The earlier cases relating to good faith, some of which were intended by Congress to be codified in Section 146 (*supra*, p. 29, note 33) give no indication that "personal disqualification" can be found on the basis of mere failure to pursue state remedies, whether the availability of such remedies is doubtful, as here, or not. Those cases in which personal disqualification amounting to bad faith was found are wholly different in degree and kind from the situation here presented. See *e. g.*, *In re Cook*, *supra*; *In re Wisun & Golub*, *supra*; *Milwaukee Postal Bldg. Corp.* v. *McCann*, 95 F. (2d) 948 (C. C. A. 8) (debtor corporation organized solely to take advantage of Section 77B; *In re North Kenmore Bldg. Corp.*, 81 F. (2d) 656 (C. C. A. 7) (same); see also, Finletter, *op. cit. supra*, pp. 74–85.

consented to state order of prompt liquidation); cf. *Struthers Furnace Co.* v. *Grant*, 30 F. (2d) 576 (C. C. A. 6).[12]

Nor can there be any thought that the conclusion of the court below will better serve orderly and successful adjustments under the procedures provided by New York. For if it be true that a debtor's petition under Chapter X is barred by its participation in state proceedings, even such limited participation as occurred in this case, a premium will be placed upon avoidance and lack of cooperation by a debtor in state proceedings. Under the rule of the court below, its cooperation in such proceedings would thereafter forever bar it from resort to the remedies afforded by Chapter X.

[12] The *Struthers Furnace Co.* case involved an ordinary bankruptcy proceeding, for which there was no statutory requirement of good faith. Nevertheless, the court undertook to decide whether the bankruptcy proceeding should be dismissed for fraud since the petitioning debtor had voluntarily submitted to, and in part instituted, a state court receivership. The court refused to vacate the bankruptcy adjudication, stating (p. 577) that "It does not follow that the corporation itself is estopped from filing a voluntary petition. Indeed, in the interest of equality of distribution between creditors, or to prevent secured creditors from proving for their entire claim instead of only for the excess over the value of the securities, or to avoid what in bankruptcy would be preferences, it may well be the duty of the corporation to file a petition in bankruptcy, despite its prior consent to an equity receivership. * * *"

Even apart from these considerations, it appears that the court below misconceived the criteria embodied in Section 146 of the Act. Once a petition has been approved, the course of the proceedings under Chapter X is in no way dependent upon whether the petition has been filed by the debtor or by creditors. Logically, therefore, if personal disqualification of the debtor justifies a determination that its petition should not be approved, a similar disqualification would act as a bar to a petition by creditors in their own interests. Thus it would seem to follow that if the debtor were here disqualified from filing a petition, the same would be true of creditors who consented to the 1934 extension or otherwise participated in the state court proceedings. Nonetheless, the court below intimated that a petition could have been approved in this case had it been filed by the creditors (R. 111). By such a conclusion, the decision below is shown to reflect no consistent appraisal of the importance of conduct in a prior proceeding. This inconsistency stems from the failure of the court below to give adequate heed to the congressional purpose, shown specifically in Section 146 (4) and by the whole statutory scheme of Chapter X, that the primary test for entertaining the proceeding under the chapter is whether proceedings would best subserve the interests of creditors and stockholders.

CONCLUSION

The judgment of the court below should be reversed.

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